Supreme Court, U.S.

OCT 9 2001

CLERK

(3)

No. 01-147

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES ZANDFORD

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

THEODORE B. OLSON
Solicitor General
Counsel of Record
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

13 pp

TABLE OF AUTHORITIES

Cases:	Page
Affiliated Ute Citizens v. *United States*, 406 U.S. 128 (1972)	7
Chiarella v. *United States*, 445 U.S. 222 (1980)	7
David Barroso, Jr., Exchange Act Release No. 43,386, 73 SEC Docket 1396 (Sept. 29, 2000)	9
Thomas V. Conwell, Exchange Act Release No. 43,006, 72 SEC Docket 2500 (July 3, 2000)	9
Shan Michael Hefley, Exchange Act Release No. 42,625, 72 SEC Docket 259 (Apr. 5, 2000)	9
Douglas J. Hopwood, Exchange Act Release No. 43,353, 72 SEC Docket 1125 (Sept. 26, 2000)	9
Janney Montgomery Scott, LLC & Norman T. Wilde, Jr. Exchange Act Release No. 43,050, 72 SEC Docket 2663 (July 18, 2000)	9
Donald J. Martineau, Exchange Act Release No. 42,422, 71 SEC Docket 1994 (Feb. 14, 2000)	9-10
Cheryl A. Rodgers, Exchange Act Release No. 43,351, 73 SEC Docket 1121 (Sept. 26, 2000)	9
SEC v. *Bulas*, Litigation Release No. 16,337, 70 SEC Docket 2887 (Oct. 15, 1999)	10
SEC v. *Christie*, Litigation Release No. 16,724, 73 SEC Docket 1348 (Sept. 26, 2000)	9
SEC v. *Conwell*, Litigation Release No. 16,420, 71 SEC Docket 1675 (Feb. 1, 2000)	10
SEC v. *Hefley*, Litigation Release No. 16,479, 71 SEC Docket 2839 (Mar. 21, 2000)	9
SEC v. *Martineau*, Litigation Release No. 16,406, 71 SEC Docket 1304 (Jan. 10, 2000)	10
SEC v. *Meridian Asset Mgmt., Inc.*, Litigation Release No. 16,638, 72 SEC Docket 3064 (July 31, 2000)	9
SEC v. *Smith*, Litigation Release No. 16,698, 73 SEC Docket 910 (Sept. 12, 2000)	9

Cases—Continued: Page

SEC v. *Sunpoint Sec., Inc.*, Litigation Release No. 16,366, 71 SEC Docket 464 (Nov. 19, 1999) 10
SEC v. *Tropeano*, Litigation Release No. 16,327, 70 SEC Docket 2502 (Oct. 5, 1999) 10
Superintendent of Ins. v. *Bankers Life & Cas. Co.*, 404 U.S. 6 (1971) 1, 7, 10
United States v. *Kendrick*, 692 F.2d 1262 (9th Cir. 1982), cert. denied, 461 U.S. 914 (1983) 1, 7, 8
United States v. *O'Hagan*, 521 U.S. 642 (1997) 6, 9

Statute and regulation:

Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*:
§ 10(b), 15 U.S.C. 78j(b) 1, 2, 3, 4, 7, 8, 9
§ 28(a), 15 U.S.C. 78bb(a) (1994 & Supp. V 1999) 10
17 C.F.R. 240.10b-5 ..... 1, 2, 3, 4, 9

Miscellaneous:

Restatement (Second) of Agency (1958) 6

In the Supreme Court of the United States

No. 01-147

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES ZANDFORD

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

This case presents the question whether a stockbroker violates Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Securities Exchange Commission (SEC) Rule 10b-5, 17 C.F.R. 240.10b-5, when he "sells his customer's securities for his own benefit and uses the proceeds for himself, without disclosure to his customer and without authorization to do so." Pet. i. The court of appeals held that such conduct does not violate Section 10(b) and Rule 10b-5. Its decision conflicts with this Court's decision in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), as well as the decision of the Ninth Circuit in *United States* v. *Kendrick*, 692 F.2d 1262 (1982), cert. denied, 461 U.S. 914 (1983). For those reasons, and because the decision in this case, if allowed to stand, will significantly impair the SEC's ability to enforce the securities laws for the protection of investors, this Court's review is warranted.

1. a. Respondent contends (Br. in Opp. 9-12) that the petition for a writ of certiorari should be denied because (he asserts) the SEC is asking this Court to decide a different question than the one decided by the court of appeals. Specifically, respondent argues that the court of appeals decided whether the "in connection with" requirement of Section 10(b) is satisfied by the charges in the indictment that led to respondent's criminal conviction, while the SEC seeks review of whether that requirement is satisfied by the allegations in the SEC's civil complaint. Respondent is wrong.

The court of appeals summarized in its opinion both the charges in the indictment and the allegations in the civil complaint, without suggesting that the facts in the criminal case differ in any material respect from the allegations in the civil complaint. See Pet. App. 2a (indictment); *id.* at 3a (complaint); see also *id.* at 5a. Then, in the pertinent portion of its opinion, the court of appeals stated that the "precise issue before [the court]" was whether the fraud alleged by the SEC—that "[respondent] defrauded the Woods by failing to inform them that he intended to sell their securities in order to obtain the proceeds for himself"—"is sufficiently connected to a securities transaction" to constitute a violation of Section 10(b) and Rule 10b-5. *Id.* at 8a. That is the very same question presented in the petition for a writ of certiorari. See Pet. i. Because the court of appeals resolved that question against the SEC as a matter of law, the court "remand[ed] with directions to dismiss the case." Pet. App. 2a; see also *id.* at 14a. Respondent's assertion (Br. in Opp. 9) that "[t]he issue presented for review was neither pressed by the

SEC below nor passed upon by the court of appeals" is thus simply wrong.[1]

b. Respondent also errs in contending (Br. in Opp. 12-16) that, if this Court grants the petition, it will have to determine whether to decide the case based on the facts alleged in the SEC's complaint or the (purportedly different) facts charged in the criminal indictment. The petition presents no question concerning the collateral estoppel effect of respondent's indictment and conviction on this civil case, and there is in any event no difference between the indictment and the complaint that

---

[1] Respondent creates some confusion by taking issue (Br. in Opp. 9, 10) with the statement in a footnote in the petition that the court of appeals "dismissed the Commission's complaint for failure to state a claim." Pet. 7 n.2. Respondent contends (Br. in Opp. 10) that the court of appeals' decision should instead be characterized as a sua sponte grant of summary judgment in favor of respondent. That contention finds no support in the pertinent portion of the court's opinion, which begins by explaining what is necessary "[t]o *state a claim*" (Pet. App. 6a (emphasis added)) under Section 10(b) and Rule 10b-5, then recites that the issue before the court is "whether [respondent's] *alleged* fraud is sufficiently connected to a securities transaction" (*id.* at 8a (emphasis added)), and concludes by holding that respondent's "*alleged* fraudulent activities were not sufficiently connected to a securities transaction to merit liability" (*id.* at 14a (emphasis added)) and directing the district court to "*dismiss*" the case (*ibid.* (emphasis added)).

In any event, it is irrelevant for present purposes how the court of appeals' disposition of the case is characterized. The critical point is that the court held that respondent's conduct, as alleged by the SEC, was outside the scope of Section 10(b) and Rule 10b-5 as a matter of law. Thus, contrary to respondent's assertion (Br. in Opp. 9, 10 n.6, 11), the government's contention is not that the court of appeals' disposition of the case is *procedurally* unfair to the SEC because the court, after having issued its ruling on the merits, should then have remanded the case to the district court rather than dismissing it outright. The contention is that the court of appeals' ruling on the merits is *substantively* incorrect, and that its judgment ordering dismissal should be reversed on *that* ground.

has any bearing on the resolution of the question presented.

i. Respondent's focus on the indictment stems from his failure to recognize that the court of appeals' decision consisted of two separate rulings, only one of which is before this Court. In its first ruling, the court reversed the district court's grant of summary judgment for the SEC, holding that respondent's criminal conviction did not, under the doctrine of collateral estoppel, establish all of the legal elements of the violations of Section 10(b) and Rule 10b-5 alleged in the complaint. Pet. App. 4a-5a. In its second ruling, the court went on to hold that the facts alleged by the SEC in its complaint do not even state a claim under Section 10(b) and Rule 10b-5. *Id.* at 8a-14a. In that portion of its opinion, the court made no mention at all of the indictment or criminal conviction—which had been submitted by the SEC with its motion for summary judgment to *prove* what had only been alleged in the complaint—and instead properly focused on what the SEC has "alleged," which obviously requires reference to the complaint. See note 1, *supra*; see also Pet. App. 3a (court summarizes allegations in SEC's complaint); *id.* at 28a-29a (relevant portions of complaint).

The petition for a writ of certiorari seeks review of only the latter ruling, not the court's holding that respondent's criminal conviction did not establish all of the legal elements of a violation of Section 10(b) and Rule 10b-5 under the doctrine of collateral estoppel. For that reason, and contrary to respondent's contention (Br. in Opp. 15-16, 19-20), there is no occasion for this Court to consider any issues concerning collateral estoppel or the facts set forth in the indictment or proven at trial in the criminal case.

The only facts that this Court need consider in deciding the question presented are those on which the court

of appeals itself relied. The court of appeals succinctly stated those facts, based on what the SEC "alleges": that respondent "defrauded the Woods by failing to inform them that he intended to sell their securities in order to obtain the proceeds for himself." Pet. App. 8a.

ii. In any event, nothing in the court of appeals' opinion suggests that the allegations in the SEC's complaint differ in any material respect from those on which the charges in the indictment or respondent's criminal conviction were based. Respondent identifies only one supposed difference—that the indictment "refers to only one investment account" but the "complaint contains several allegations regarding a mutual fund account." Br. in Opp. 13-14. The court of appeals, however, expressly stated *its* understanding that the "first count [of the indictment] maintained that [respondent] sold the Woods' shares of a mutual fund in order to use the proceeds for his own benefit." Pet. App. 2a. Indeed, that was how the court of appeals had previously described the first count of the indictment when it affirmed respondent's conviction. See *id.* at 35a ("The first count related to money [respondent] obtained from selling the Woods' shares in a mutual fund.").

Even if the indictment had not encompassed respondent's fraudulent sales of the mutual fund shares but only his fraudulent sales of the Woods' other securities in their brokerage account, that would have no bearing on the resolution of the legal issue decided by the court of appeals and presented by the petition for certiorari. Respondent contends (Br. in Opp. 14-15) that the difference is "critical" because the court of appeals noted that the Woods' brokerage account was a discretionary one, in which respondent could trade securities without obtaining the Woods' prior approval. See Pet. App. 10a. Respondent also implies (without actually stating) that

he did not have comparable authority over the Woods' mutual fund holdings. See Br. in Opp. 15. In fact, nothing in the record suggests that respondent's authority over the Woods' mutual fund holdings was any different than his authority over the brokerage account, and the SEC does not contend that it was.

Moreover, whether respondent had discretionary authority to sell the Woods' securities (including their mutual funds) or first had to obtain their permission for any sales has no bearing on the question whether respondent's deception concerning his intent to misappropriate the sales proceeds was "in connection with" his sale of the Woods' securities. The requisite connection was present because the sale of the securities was the means by which respondent generated the cash he stole, and his deception concerning his intent in selling the securities left the Woods without information that would have enabled them to act to prevent those sales. See Pet. 9.

Nor does respondent's discretionary authority to trade without obtaining prior approval from the Woods render his conduct any less fraudulent and unauthorized. Respondent's discretionary authority to trade was limited to transactions for the Woods' benefit. See Restatement (Second) of Agency § 387 (1958) ("Unless otherwise agreed, an agent is subject to a duty to his principal to act solely for the benefit of the principal in all matters connected with his agency."). Absent disclosure to and consent by the Woods, respondent could not exercise his discretionary authority by selling their securities in order to use the proceeds to enrich himself. Cf. *United States* v. *O'Hagan*, 521 U.S. 642, 654-655 (1997).

2. Respondent is also incorrect in asserting (Br. in Opp. 17-22) that the court of appeals' decision does not conflict with any decision of this Court or any court of

appeals. As explained in the petition (at 13-17), the decision in this case conflicts both with this Court's decision in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971), and with the Ninth Circuit's decision in *United States* v. *Kendrick*, 692 F.2d 1262 (1982), cert. denied, 461 U.S. 914 (1983).

a. Respondent attempts to distinguish *Bankers Life* by arguing (Br. in Opp. 19) that it involved a misrepresentation that induced the securities sale. The facts in this case, however, are not materially different. As noted by the court of appeals, the SEC alleged that respondent defrauded the Woods in connection with securities sales by failing to inform them that he intended to sell their securities in order to misappropriate the proceeds. See Pet. App. 8a. Respondent's failure to disclose his plans deprived the Woods of the opportunity to prevent the sales. Thus, respondent's failure to disclose was instrumental to the sales in this case just as much as the misrepresentation in *Bankers Life* was instrumental to the sale in that case. Whether the deception that causes a securities transaction is accomplished through an omission or an affirmative misrepresentation has no legal significance with regard to whether the deception is "in connection with the purchase or sale of any security," as required by Section 10(b). See Pet. 14-15; *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153 (1972); *Chiarella* v. *United States*, 445 U.S. 222, 228 (1980).

Respondent also cannot distinguish *Bankers Life* on the ground that the court of appeals "correctly concluded" that his "fraudulent activities were not sufficiently connected to a securities transaction where the evidence established by the SEC based on its collateral estoppel theory only established that funds were converted from a securities account and the actual role of securities in the fraud is not established" (Br. in Opp.

19-20). As explained above (see pp. 3-5, *supra*), the question of what the SEC affirmatively established (not merely alleged) by relying on respondent's criminal conviction is not presented in the certiorari petition. Furthermore, the distinction that respondent would draw rests on a mischaracterization of the basis for the court of appeals' decision. The decision did not rest on a factual conclusion that the SEC failed to establish the role of securities in respondent's fraud, but on a legal conclusion that respondent did not violate Section 10(b) even if, as the SEC alleged, he "defrauded the Woods by failing to inform them that he intended to sell their securities in order to obtain the proceeds for himself." Pet. App. 8a.

b. Respondent's attempt (Br. in Opp. 20) to explain away the conflict with the Ninth Circuit's decision in *Kendrick* is based on the irrelevant distinction that *Kendrick* "involved securities in non-discretionary margin accounts." As discussed above, whether the securities sales occurred in a discretionary or a non-discretionary account has no bearing on the legal issue in this case. See p. 6, *supra*. Respondent also incorrectly contends (Br. in Opp. 20) that, in *Kendrick*, there was a "direct link" with the securities transaction that is lacking in this case. Just as Kendrick was engaged in fraud when he "caused Dean Witter to issue the checks" on the margin account in order to convert the money to his own use (692 F.2d at 1265), so too respondent was engaged in fraud when he caused the Woods' securities to be liquidated in order to convert to his own use the money "generated" by the sales (Pet. App. 2a; see also *id.* at 28a, 41a).

c. Contrary to respondent's contention (Br. in Opp. 18), the petition's reliance on *O'Hagan* (see Pet. 9-13) does not "wrench[] *O'Hagan* from the context in which it was decided." The rationale of this Court in finding

that O'Hagan's fraudulent conduct was "in connection with" his securities transactions applies to this case. See Pet. 9-10. This Court stated in *O'Hagan* that the "in connection with" element "is satisfied because the fiduciary's fraud is consummated * * * when the fiduciary, * * * without disclosure to his principal," uses the principal's confidential information in trading securities for personal profit. 521 U.S. at 656. Similarly, in this case, respondent's fraud was consummated when he sold the securities of his principals and converted the proceeds for his own benefit, without disclosing his intentions to them.

3. Finally, contrary to respondent's assertions (Br. in Opp. 22-23), the holding of the court of appeals that a stockbroker's fraudulent conversion of securities and their proceeds does not violate Section 10(b) and Rule 10b-5 will significantly impair the SEC's ability to protect investors. In fiscal year 2000 alone, the SEC used those general antifraud provisions to bring 16 administrative proceedings and civil actions against securities firms and their personnel for fraudulently misappropriating customer property.[2]

---

[2] *David Barroso, Jr.*, Exchange Act Release No. 43,386, 73 SEC Docket 1396 (Sept. 29, 2000); *Douglas J. Hopwood*, Exchange Act Release No. 43,353, 73 SEC Docket 1125 (Sept. 26, 2000); *Cheryl A. Rodgers*, Exchange Act Release No. 43,351, 73 SEC Docket 1121 (Sept. 26, 2000); *SEC* v. *Christie*, Litigation Release No. 16,724, 73 SEC Docket 1348 (Sept. 26, 2000); *SEC* v. *Smith*, Litigation Release No. 16,698, 73 SEC Docket 910 (Sept. 12, 2000); *SEC* v. *Meridian Asset Mgmt., Inc.*, Litigation Release No. 16,638, 72 SEC Docket 3064 (July 31, 2000); *Janney Montgomery Scott LLC & Norman T. Wilde, Jr.*, Exchange Act Release No. 43,050, 72 SEC Docket 2663 (July 18, 2000); *Thomas V. Conwell*, Exchange Act Release No. 43,006, 72 SEC Docket 2500 (July 3, 2000); *Shan Michael Hefley*, Exchange Act Release No. 42,625, 72 SEC Docket 259 (Apr. 5, 2000); *SEC* v. *Hefley*, Litigation Release No. 16,479, 71 SEC Docket 2839 (Mar. 21, 2000); *Donald J. Martineau*,

Although it is true, as respondent points out (Br. in Opp. 22), that actions against brokers who fraudulently convert securities or securities proceeds from brokerage accounts could also be brought by persons or entities other than the SEC under other state and federal laws, this Court and Congress have made clear that the existence of remedies under other laws does not preclude the existence of an action under the federal securities laws. *Bankers Life*, 404 U.S. at 12; 15 U.S.C. 78bb(a) (1994 & Supp. V 1999) (subject to limited exceptions not relevant here, "the rights and remedies provided by [the Securities Exchange Act] shall be in addition to any and all other rights and remedies that may exist in law and equity"). It is essential that the agency principally responsible for enforcing the federal securities laws be able to take action to protect brokerage firm customers from fraudulent conversions of their assets.

* * * * *

For the reasons stated above and in the petition for a writ of certiorari, the petition should be granted.

Respectfully submitted.

THEODORE B. OLSON
Solicitor General

OCTOBER 2001

Exchange Act Release No. 42,422, 71 SEC Docket 1994 (Feb. 14, 2000); *SEC* v. *Conwell*, Litigation Release No. 16,420, 71 SEC Docket 1675 (Feb. 1, 2000); *SEC* v. *Martineau*, Litigation Release No. 16,406, 71 SEC Docket 1304 (Jan. 10, 2000); *SEC* v. *Sunpoint Sec., Inc.*, Litigation Release No. 16,366, 71 SEC Docket 464 (Nov. 19, 1999); *SEC* v. *Bulas*, Litigation Release No. 16,337, 70 SEC Docket 2887 (Oct. 15, 1999); *SEC* v. *Tropeano*, Litigation Release No. 16,327, 70 SEC Docket 2502 (Oct. 5, 1999).